Things in a 401(k) Plan That Just Don't Look Right

By Ary Rosenbaum, Esq.

I always say that if things don't look right even if they are, it will give people the impression that something is wrong. It's similar to the expression: "When there's smoke, there's fire." A plan sponsor can't afford to create impressions that there is something wrong with their plan because they don't the hassle and cost of dealing with possible litigation and government investigations. There are certain things a plan sponsor should avoid and this article is all about stuff in a 401(k) plan that doesn't look right and that might make the wrong impression.

Hiring Relatives As Plan Providers

They say that charity begins at home, but that shouldn't involve a retirement plan. A retirement plan sponsor will hire a relative of one of the owners or employees as a plan provider and it just looks bad. It doesn't mean that the retirement plan provider is qualified or not, it just doesn't look right. I always believe that anything that looks improper will be labeled as being improper and it's hard to shake off labels. Nepotism implies that someone just got a position just because they are related to someone. How many times have you seen the boss' child get hired and you know the only they got hired was because they were related? A selection of plan providers should be an unbiased process that looks at various factors, selecting someone that's a relative gives the impression that you are not being on the level. When my father got me a summer job working for his electrical contracting business, it wasn't a big issue because it was a privately owned company owned by him and his partner. A retirement plan has to answer to a higher authority because being a plan sponsor and plan fiduciary requires a higher level of duty of care. So that means nepotism is something that gives the appearance that the plan fiduciary is doing something improper. If things look bad, then maybe people will think that the plan is doing something bad.

Not having an Investment Policy Statement (IPS)

An IPS is drafted for a retirement plan that describes a plan's criteria for selecting and replacing investments whether the plan's investments are directed by the trustees or by plan participants. While I always state that a retirement plan should have an IPS, it's actually not legally required. While it's not legally required, all plans should have one. The reason they should have one is that having a retirement plan and staying out of trouble in sponsoring one is all about following a process. For example, retirement plans won't land into legal hot water if participants lose money in the account where they direct their investment. However, they will land into legal hot water if they don't have a process in place to prudently select plan investments and provide education to plan participants. An IPS is evidence of a process, it is a policy statement that details how and why plan investments are selected and replaced. Of course, with any legal document, it has to be followed. An IPS that a plan sponsor does not follow is worse than not having an IPS altogether because failure to follow an IPS is a failure of the fiduciary process.

Not having a financial advisor

A financial advisor is an integral part of a retirement plan. Once you have employees, it's paramount for the plan to have one. Even if the retirement plan only offers index fund options, advisors are a necessary part because picking investment options is just one small function of their job. The fiduciary process for a retirement plan is one that can land a plan sponsor in trouble for not having a good one in place, so the retirement plan needs a professional. It needs someone who knows how to select investments, know how to put the proper procedures in place and also knows how to get participants ready to select their own investments. In addition, a good financial advisor also acts as an ombudsman when there are issues with other plan providers and they don't even charge for that. They act as your advocate and help you out, far more than just picking mutual funds. While a monkey may be able to get a good investment lineup, a monkey can't help you manage the fiduciary process and

help the plan out. A good financial advisor can do that.

Using the same mutual fund company for almost every investment option

When you sell a product or service, distribution is probably one of the most important issues in business. The more distribution, the more likely you're your product or service will be sold. Consumers need to be able to buy your product or service for you to make money, that's just common business sense. Mutual fund companies are in the TPA/ record-keeping business because it's a great way for the wider distribution of their mutual funds. Many retirement plans got these mutual company providers because they like the fund company. A retirement plan that goes to Fidelity for their TPA service isn't going there because they like T. Rowe Price or Vanguard funds because those mutual fund companies also offer those types of TPA services. The problem with selecting these providers is that there are retirement plan sponsors who overdose on those plan provider mutual funds. I will never forget a retirement plan that had 12 -15 mutual funds, all from the same fund family. There is no mutual fund family that is perfect in every asset class, sector, or style. The fiduciary process is all about selecting the best investment options out there and if all the investments are from the very same mutual fund family, it gives the appearance that the best wasn't selected. It's not an issue to select investment options that happen to be the proprietary funds of the plan provider, it becomes an issue when it's the dominant reason for its selection.

Low participation rate on the 401(k) portion

Small employers will always have plans with a small amount of assets. The problem is when you have a plan that is small for its size of employees because it has a low participation rate for the 401(k) salary deferral portion of the plan. A low rate of participation on the deferral side is a problem for the plan's discrimination testing and it also presents a problem that the plan isn't being run correctly if there is such a disinterest in the plan. Disinterest can be for many reasons, so as low pay for its employees, but also because of a failure in the fiduciary process to get employees involved in deferring. From my experience, the issue has usually been the latter. A low participation rate on their deferral often deals with a lack of information provided to plan participants. In addition, studies have shown that plans with larger fund lineups tend to have depressed participation rates because too many investment options lead to confusion for plan participants which leads to apathy. Regardless of the reason, a low participation rate doesn't look right and usually indicates that a plan sponsor isn't doing something right.

Not benchmarking fees on a consistent basis

A retirement plan sponsor has the fiduciary duty to make sure that plan costs are reasonable and the only way for plan sponsors to find out whether the fees are reasonable or not is to benchmark them against what other providers are charging for the same level of service. Fee disclosure regulations that require plan providers to provide fee disclosure to the plan sponsor is a good thing but only as good as whether the plan sponsor uses them. Too many plan sponsors throw their disclosure in the garbage or in the back of the drawer, maybe some use it to wrap fish. Plan sponsors that don't benchmark fees on a consistent basis are indicating that they are not exercising their fiduciary duty in a prudent manner.

Consistently failing compliance tests

401(k) plans go through many compliance tests to make sure that the plan does not discriminate in favor of highly compensated employees. Failed compliance tests will be corrected either through a required contribution or refunds to highly compensated employees that will require them to pay taxes on these distributions. There is a plan design features that can make the plan automatically pass most of these compliance tests by making required safe harbor contributions to non-highly compensated employees that can also be used in tandem with a cross-tested allocation or defined benefit/cash balance plan that can reward highly compensated employees with more contributions. Consistently failing compliance tests is an indication that the plan does not have an effective plan design.

Late deposits on deferrals

The Department of Labor (DOL) had a reinterpretation of guidance years ago, about salary deferrals. While the original guidance said that plan sponsors were OK with depositing participant salary deferrals by the 15th day of the following money, the DOL came out and said it had to be as soon as possible. Right now, it is the most popular 401(k) error. The problem is that it's also a question on Form 5500 and late deposits may bring a government audit onto the plan and it needs to be corrected. I also find that most plan sponsors never make late deferral deposits just once, it happens multiple times.

THE ROSENBAUM LAW FIRM P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw